SONIC FOUNDRY INC
Form 10-Q
August 06, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly period ended June 30, 2007

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 1-14007

SONIC FOUNDRY, INC.

(Exact name of registrant as specified in its charter)

MARYLAND	**39-1783372**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

222 West Washington Ave, Madison, WI 53703

(Address of principal executive offices)

(608) 443-1600

(Registrant s telephone number including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (see definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act).

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

State the number of shares outstanding of each of the issuer s common equity as of the last practicable date:

Class	Outstanding July 30, 2007
Common Stock, $0.01 par value	35,541,836

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Sonic Foundry, Inc.

Consolidated Balance Sheets

(in thousands, except for share data)

(Unaudited)

	June 30, 2007	September 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 8,354	$ 2,751
Accounts receivable, net of allowances of $260 and $160	5,679	3,442
Inventories	85	398
Prepaid expenses and other current assets	1,103	399
Total current assets	15,221	6,990
Property and equipment:		
Leasehold improvements	975	893
Computer equipment	2,295	2,275
Furniture and fixtures	461	422
Total property and equipment	3,731	3,590
Less accumulated depreciation	1,392	1,296
Net property and equipment	2,339	2,294
Other assets:		
Goodwill and other intangibles, net of amortization of $1,400 and $1,346	7,599	7,628
Total assets	$ 25,159	$ 16,912
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 1,465	$ 1,521
Accrued liabilities	1,115	1,225
Unearned revenue	3,122	2,005
Current portion of notes payable	342	
Current portion of capital lease obligation	44	41
Total current liabilities	6,088	4,792
Long-term portion of notes payable	630	
Long-term portion of capital lease obligation	107	78
Other liabilities	371	441
Total liabilities	7,196	5,311
Stockholders equity:		
Preferred stock, $.01 par value, authorized 5,000,000 shares; none issued and outstanding		
5% preferred stock, Series B, voting, cumulative, convertible, $.01 par value (liquidation preference at par), authorized 10,000,000 shares, none issued and outstanding		
	357	322

Common stock, $.01 par value, authorized 100,000,000 shares; 35,657,337 and 32,266,217 issued and 35,530,170 and 32,195,967 outstanding at June 30, 2007 and September 30, 2006, respectively		
Additional paid-in capital	183,292	172,033
Accumulated deficit	(165,491)	(160,560)
Receivable for common stock issued	(26)	(26)
Treasury stock, at cost, 127,167 shares at June 30, 2007, and 70,250 shares at September 30, 2006	(169)	(168)
Total stockholders equity	17,963	11,601
Total liabilities and stockholders equity	$ 25,159	$ 16,912

See accompanying notes

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Sonic Foundry, Inc.

Consolidated Statements of Operations

(in thousands, except for share and per share data)

(Unaudited)

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Nine Months Ended June 30, 2007	Nine Months Ended June 30, 2006
Revenue:				
Product	$ 3,544	$ 2,967	$ 9,028	$ 6,601
Services	1,148	663	2,939	1,730
Other	10	17	29	141
Total revenue	4,702	3,647	11,996	8,472
Cost of revenue:				
Product	1,095	812	2,628	2,233
Services	131		262	
Total cost of revenue	1,226	812	2,890	2,233
Gross margin	3,476	2,835	9,106	6,239
Operating expenses:				
Selling and marketing expenses	3,354	2,101	8,900	5,569
General and administrative expenses	952	744	3,027	2,206
Product development expenses	837	593	2,318	1,671
Total operating expenses	5,143	3,438	14,245	9,446
Loss from operations	(1,667)	(603)	(5,139)	(3,207)
Other income, net	77	20	208	65
Net loss	$ (1,590)	$ (583)	$ (4,931)	$ (3,142)
Net loss per common share:				
basic and diluted	$ (0.04)	$ (0.02)	$ (0.14)	$ (0.10)
Weighted average common shares				
basic and diluted	35,504,939	31,994,713	34,400,290	31,663,048

See accompanying notes

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Sonic Foundry, Inc.

Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Nine months ended June 30, 2007	2006
Operating activities		
Net loss	$ (4,931)	$ (3,142)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of goodwill, other intangibles, and capitalized software development costs	53	247
Depreciation and amortization of property and equipment	472	267
Loss on sale of fixed assets	1	
Provision for doubtful accounts	100	(5)
Other non-cash items	(59)	
Share-based compensation expense related to stock warrants and options	590	539
Changes in operating assets and liabilities:		
Accounts receivable	(2,337)	(1,101)
Inventories	295	173
Prepaid expenses and other current assets	(432)	(47)
Accounts payable and accrued liabilities	(220)	(123)
Other long-term liabilities	(70)	(4)
Unearned revenue	922	612
Total adjustments	(685)	558
Net cash used in operating activities	(5,616)	(2,584)
Investing activities		
Purchases of property and equipment	(397)	(531)
Net cash used in investing activities	(397)	(531)
Financing activities		
Proceeds from notes payable, net of capitalized loan fees	976	
Payments on notes payable	(28)	
Proceeds from issuance of common stock, net of issuance costs	10,703	1,174
Payments on capital leases	(35)	(15)
Net cash provided by financing activities	11,616	1,159
Net increase (decrease) in cash	5,603	(1,956)
Cash and cash equivalents at beginning of period	2,751	4,271
Cash and cash equivalents at end of period	$ 8,354	$ 2,315
Supplemental cash flow information:		
Non-cash operating and investing activities -		
Property and services acquired by barter	$	$ 40
Property and services acquired by capital lease	67	61
Property and equipment financed by accounts payable and accrued liabilities	54	

See accompanying notes

Sonic Foundry, Inc.

Notes to Consolidated Financial Statements

June 30, 2007

(Unaudited)

1. Basis of Presentation and Significant Accounting Policies

Sonic Foundry, Inc. (the Company) is in the business of developing automated rich media application software and systems (our Rich Media business).

Interim Financial Data

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States (GAAP) for complete financial statements and should be read in conjunction with the Company s annual report filed on Form 10-K for the fiscal year ended September 30, 2006. In the opinion of management, all adjustments (consisting only of adjustments of a normal and recurring nature) considered necessary for a fair presentation of the results of operations have been included. Operating results for the three and nine month periods ended June 30, 2007 are not necessarily indicative of the results that might be expected for the year ending September 30, 2007.

Revenue Recognition

General

Revenue is recognized when persuasive evidence of an arrangement exists, delivery occurs or services are rendered, the sales price is fixed or determinable and collectibility is reasonably assured. Revenue is deferred when undelivered products or services are essential to the functionality of delivered products, customer acceptance is uncertain, significant obligations remain, or the fair value of undelivered elements is unknown. The Company does not offer customers the right to return product, other than for warranty repairs. The Company s policy is to reduce revenue if it incurs an obligation for price rebates or other such programs during the period the obligation is reasonably estimated to occur. The following policies apply to the Company s major categories of revenue transactions.

Products

Products are considered delivered, and revenue is recognized, when title and risk of loss have been transferred to the customer. Under the terms and conditions of the sale, this occurs at the time of shipment to the customer. Product revenue currently represents sales of our Mediasite product and Mediasite related products such as server software revenue.

Services

We sell support contracts to our Mediasite customers, typically one year in length and record the related revenue ratably over the contractual period. Our support contracts cover phone and electronic technical support availability over and above the level provided by our distributors, software upgrades, advance replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturer we contract with to build the units performs hardware warranty service. We also provide installation, training and event services as well as services to host customer Mediasite content. Revenue for those services is recognized when performed in the case of installation, training and event services and is recognized ratably over the contract period for hosting services. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

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Other

Other revenue consists of custom software development where we recognize fees recorded pursuant to long-term contracts (including research grants), using the percentage of completion method of accounting, when significant customization or modification of a product is required. Shipping and handling is recorded at the time of shipment to the customer.

Revenue Arrangements that Include Multiple Elements

Revenue for transactions that include multiple elements such as hardware, software, training, support or content hosting agreements is allocated to each element based on its relative fair value and recognized for each element when the revenue recognition criteria have been met for that element. Fair value is generally determined based on the price charged when the element is sold separately. In the absence of fair value of a delivered element, revenue is allocated first to the fair value of the undelivered elements and the residual revenue to the delivered elements. The Company recognizes revenue for delivered elements only when all of the following criteria are satisfied: undelivered elements are not essential to the functionality of delivered elements, uncertainties regarding customer acceptance are resolved, and the fair value for all undelivered elements is known.

Shipping and Handling

The Company s shipping and handling costs billed to customers are included in other revenue. Costs related to shipping and handling are included in cost of revenue and are recorded at the time of shipment to the customer.

Concentration of Credit Risk and Other Risks and Uncertainties

The Company s cash and cash equivalents are deposited with two major financial institutions. At times, deposits in these institutions exceed the amount of insurance provided on such deposits. The Company has not experienced any losses on such amounts and believes that it is not exposed to any significant risk on these balances.

We perform ongoing credit evaluations of our customers financial condition and generally do not require collateral. We maintain allowances for potential credit losses and such losses have been within our expectations.

Reclassifications

Certain amounts reported in previous periods have been reclassified to conform to the current period presentation.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Inventory Valuation

Inventory consists of raw materials and supplies used in the assembly of Mediasite units and finished Mediasite units. Inventory of completed Mediasite units and spare parts are carried at the lower of cost or market, with cost determined on a first-in, first-out basis. Inventory consists of the following (in thousands):

	6/30/07	9/30/06
Raw materials and supplies	$ 10	$ 10
Finished goods	75	388
	$ 85	$ 398

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Stock Based Compensation

The Company maintains an employee qualified stock option plan under which the Company may grant options to acquire up to 7.0 million shares of common stock. The Company also maintains a non-qualified plan under which 3.8 million shares of common stock can be issued and a directors stock option plan under which 900 thousand shares of common stock may be issued to non-employee directors. Each non-employee director, who is re-elected or who is continuing as a member of the board of directors on the annual meeting date and on each subsequent meeting of stockholders, is granted options to purchase 20 thousand shares of common stock.

Each option entitles the holder to purchase one share of common stock at the specified option price. The exercise price of each option granted under the plans was set at the fair market value of the Company s common stock at the respective grant date. Options vest at various intervals and expire at the earlier of termination of employment, discontinuance of service on the board of directors, ten years from the grant date or at such times as are set by the Company at the date of grant.

Effective October 1, 2005, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123R, Share-Based Payment an Amendment of FASB Statement Nos. 123 and 95, (SFAS 123R) for its stock option plans. The Company previously accounted for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and related interpretations and disclosure requirements established by Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation, (SFAS 123), as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure.

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized for the three and nine month periods ended June 30, 2007, and 2006 includes the cost associated with stock options vesting during the period which were granted prior to, but not yet vested as of October 1, 2005. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to September 30, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period. There were no capitalized stock-based compensation costs at June 30, 2007.

Upon the adoption of SFAS 123R, the Company changed its option valuation model from the Black-Scholes model to a lattice valuation model for all stock options granted subsequent to September 30, 2005. The lattice valuation model is a more flexible analysis to value employee options because of its ability to incorporate inputs that change over time, such as actual exercise behavior of option holders. The Company used historical data to estimate the option exercise and employee departure behavior used in the lattice valuation model. Expected volatility is based on historical volatility of the Company s stock. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The Company considers all employees to have similar exercise behavior and therefore has not identified separate homogenous groups for valuation. The expected term of options granted is derived from the output of the option pricing model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the options is based on the U.S. Treasury yields in effect at the time of grant.

The fair value of each option grant is estimated using the assumptions in the following table:

	Three months ended June 30,	
	2007	**2006**
Method	Lattice	Lattice
Expected life (years)	5.7 years	5.3 years
Risk-free interest rate	4.60%	5.00%
Expected volatility	65.41%	71.09%
Expected dividend yield	0%	0%

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A summary of option activity as of June 30, 2007 and changes during the nine months then ended is presented below:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Period	Aggregate Intrinsic Value
Outstanding at October 1, 2006	4,602,174	$ 2.17	6.3	$ 4,598,905
Granted	563,085	3.65	9.5	0
Exercised	(353,002)	1.36	4.3	307,967
Forfeited	(86,269)	2.31	7.7	27,394
Outstanding at June 30, 2007	4,725,988	$ 2.41	6.1	$ 3,764,276
Exercisable at June 30, 2007	3,537,798	$ 2.41	5.1	$ 3,264,393

A summary of the status of the Company s non-vested shares and changes during the nine month periods ended June 30, 2007 and 2006 are presented below:

	June 30, 2007		June 30, 2006	
		Weighted-Average Grant Date		Weighted-Average Grant Date
Non-vested Shares	Shares	Fair Value	Shares	Fair Value
Non-vested at October 1,	1,124,514	$ 1.06	1,006,347	$ 0.94
Granted	563,085	1.95	644,000	0.76
Vested	(424,915)	1.01	(459,831)	0.73
Forfeited	(74,495)	1.33	(126,002)	1.11
Non-vested at June 30,	1,188,190	$ 1.38	1,064,514	$ 1.03

The weighted average grant date fair value of options granted during the nine months ended June 30, 2007 was $1.95. As of June 30, 2007, there was $705 thousand of total unrecognized compensation cost related to non-vested share-based compensation, net of $258 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average remaining life of 1.5 years.

Stock-based compensation recorded in the three month period ended June 30, 2007 of $202 thousand was allocated $128 thousand to selling and marketing expenses, $28 thousand to general and administrative expenses and $46 thousand to product development expenses. Stock-based compensation recorded in the nine month period ended June 30, 2007 of $590 thousand was allocated $378 thousand to selling and marketing expenses, $79 thousand to general and administrative expenses and $133 thousand to product development expenses. Cash received from Option exercises under all stock option plans for the three and nine month periods ended June 30, 2007 was $69 thousand and $479 thousand, respectively, compared to $223 thousand and $273 thousand for the three and nine month periods ended June 30, 2006, respectively. There were no tax benefits realized for tax deductions from option exercises in either of the three month periods ended June 30, 2007 and 2006. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

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Per share computation

The numerator for the calculation of basic and diluted earnings per share is net loss. The following table sets forth the computation of basic and diluted loss per share:

	Three Months Ended June 30, 2007	2006	Nine Months Ended June 30, 2007	2006
Denominator				
Denominator for basic and diluted loss per share weighted average common shares	35,504,939	31,994,713	34,400,290	31,663,048
Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive:				
Options and warrants	5,284,896	5,182,372	5,284,896	5,182,372

New Accounting Pronouncements

In June 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes . This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN No. 48 is not expected to have any significant effect on the Company s consolidated financial position or results of operations.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108), Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statement. Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. We do not believe SAB 108 will have a material impact on our results of operations or financial position.

2. Related Party Transactions

During the three and nine month periods ended June 30 , 2007, the Company paid fees of $129 and $225 thousand, respectively, to a law firm, a partner of which is a director and stockholder of the Company. The Company had accrued liabilities for unbilled services of $92 and $69 thousand for the periods ended June 30, 2007 and 2006 respectively, to the same law firm.

During the three and nine month periods ended June 30, 2007, the Company recorded Mediasite product and customer support billings of $127 and $452 thousand, respectively, to MSKK, a Japanese reseller in which the Company has an equity interest. The Company recorded billings of $31 and $430 thousand in the three and nine month periods ended June 30, 2006, respectively.

During the three and nine month period ended June 30, 2007, the Company entered into two transactions with an entity in which a member of the Company s Board of Directors is a significant shareholder. The transactions included billings of $173 thousand and $57 thousand for the Company s products and services in exchange for advertising services. The Company recognized $97 thousand of revenue during the nine-month period ended June 30, 2007 and deferred $133 thousand of revenue at June 30, 2007. No sales were recorded during the nine months ended June 30, 2006.

As of June 30, 2007 and 2006, the Company had a loan outstanding to an executive totaling $26 thousand. This loan is secured by company stock.

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3. Purchase Commitments

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. Obligations to purchase approximately $815 thousand over the next fiscal quarter remain. This commitment is not recorded on the Company s Balance Sheet. There are no obligations under this commitment past September 30, 2007. The Company had $1.6 million of purchase commitments as of June 30, 2006.

The Company engaged a manufacturer to build a replacement component for its Mediasite product according to designs proprietary to the Company. The Company had a commitment of approximately $69 thousand at June 30, 2007. There was no similar commitment at June 30, 2006.

4. Borrowing Arrangements

On May 2, 2007, the Company and its wholly-owned subsidiary, Sonic Foundry Media Systems, Inc. (collectively, the Companies) entered into a Loan and Security Agreement (the Loan Agreement) with Silicon Valley Bank providing for a credit facility in the form of a $3,000,000 secured revolving line of credit and a $1,000,000 term loan. The revolving line of credit will accrue interest at a per annum rate equal to the greater of (i) one-quarter of one percentage point (0.25%) above Silicon Valley Bank s Prime Rate, or (ii) eight percent (8%). The term loan accrues interest at a per annum rate equal to the greater of (i) one percent (1%) above Silicon Valley Bank s Prime Rate, or (ii) eight and three quarters percent (8.75%). Interest on the revolving line of credit and interest on the term loan is payable monthly. The revolving line of credit matures on April 30, 2009, at which time all outstanding borrowings and any unpaid interest thereon must be repaid, and all outstanding letters of credit must be cash collateralized. Principal on the term loan will be repaid in thirty-six (36) equal monthly installments, and will be repaid in full on May 1, 2010. The term loan provides funds for the Company s recently completed facility expansion while the revolving line of credit provides flexibility in financing growth in the future, if and when the Company determines it is advisable to do so. At June 30, 2007 a balance of $972,000 was remaining on the term loan with no outstanding balance on the revolving line of credit.

The Loan Agreement contains certain financial covenants, including a covenant requiring the Companies to maintain certain of their depository, operating and securities accounts with Silicon Valley Bank, maintain a tangible net worth covenant, and maintain certain ratios of quick assets to current liabilities minus deferred revenue. The Loan Agreement also contains certain other restrictive loan covenants, including covenants limiting the Companies ability to dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens, make investments, pay dividends, and repurchase stock. The Company was in compliance with all covenants at June 30, 2007.

The Loan Agreement contains events of default that include, among others, non-payment of principal or interest, inaccuracy of any representation or warranty, violation of covenants, bankruptcy and insolvency events, material judgments, cross defaults to certain other indebtedness, and material adverse changes. The occurrence of an event of default could result in the acceleration of the Companies obligations under the Loan Agreement.

Pursuant to the Loan Agreement, the Company and its wholly-owned subsidiary pledged as collateral to the Bank substantially all of their non-intellectual property business assets, and each of the Company and its wholly-owned subsidiary entered into an Intellectual Property Security Agreement with respect to their intellectual property assets.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Risks and Uncertainties

The following discussion of the consolidated financial position and results of operations of the Company should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this form 10-Q and the Company s annual report filed on form 10-K for the fiscal year ended September 30, 2006. In addition to historical information, this discussion contains forward-looking statements such as statements of the Company s expectations, plans, objectives and beliefs. These statements use such words as may, will, expect, anticipate, believe, plan, and other similar terminology.

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Actual results could differ materially from expectations due to changes in the market acceptance of our products, competition, market introduction or product development delays; all of which would impact our strategy to develop a network of inside regional sales managers and distribution partners that target customer opportunities for multi-unit and repeat purchases. If the Company does not achieve multi-unit and repeat purchases our business will be harmed.

Other factors that may impact actual results include: our ability to effectively integrate acquired businesses, length of time necessary to close on sales leads to multi-unit purchasers, our ability to service existing accounts, global and local business conditions, legislation and governmental regulations, competition, our ability to effectively maintain and update our product portfolio, shifts in technology, political or economic instability in local markets, and currency and exchange rate fluctuations, as well as other issues which may be identified from time to time in Sonic Foundry s Securities and Exchange Commission filings and other public announcements.

Overview

Sonic Foundry, Inc. is a technology leader in the emerging web communications marketplace, providing enterprise solutions and services that link an information-driven world. The company s principal product line, Mediasite , is a web communication and content management system that automatically and cost-effectively webcasts lectures and presentations. Trusted by Fortune 500 companies, top education institutions and Federal, state and local government agencies for a variety of critical communication needs, Mediasite is the leading one-to-many multimedia communication solution for capturing knowledge and sharing it online.

New Accounting Pronouncements

In June 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes . This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN No. 48 is not expected to have any significant effect on the Company s consolidated financial position or results of operations.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108), Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statement. Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. We do not believe SAB 108 will have a material impact on our results of operations or financial position.

Critical Accounting Policies

We have identified the following as critical accounting policies to our Company and have discussed the development, selection of estimates and the disclosure regarding them with the audit committee of the board of directors:

- Revenue recognition and allowance for doubtful accounts;
- Impairment of long-lived assets;
- Valuation allowance for net deferred tax assets; and
- Accounting for stock-based compensation.

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Revenue Recognition and Allowance for Doubtful Accounts

We recognize revenue for product sales and licensing of software products upon shipment, provided that collection is determined to be probable and no significant obligations remain. The Company does not offer rights of return and typically delivers products either to value added resellers based on end-user customer orders or direct to the end user. We sell post-contract support (PCS) contracts on our Mediasite units. Revenue is recorded separately from the sale of the product and recognized over the life of the support contract using vendor specific objective evidence of the value of the support services. Please refer to Note 1 of our Notes to Consolidated Financial Statements for further information on our revenue recognition policies.

The preparation of our consolidated financial statements also requires us to make estimates regarding the collectability of our accounts receivables. We specifically analyze the age of accounts receivable and historical bad debts, customer concentrations, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts.

Impairment of long-lived assets

We assess the impairment of goodwill, other intangibles and capitalized software development costs on an annual basis or whenever events or changes in circumstances indicate that the fair value of these assets is less than the carrying value. Factors we consider important which could trigger an impairment review include the following:

- poor economic performance relative to historical or projected future operating results;
- significant negative industry, economic or company specific trends;
- changes in the manner of our use of the assets or the plans for our business; and
- loss of key personnel

If we determine that the fair value of goodwill is less than its carrying value, based upon the annual test or the existence of one or more of the above indicators of impairment, we would then measure impairment based on a comparison of the implied fair value of goodwill with the carrying amount of goodwill. To the extent the carrying amount of goodwill is greater than the implied fair value of goodwill, we would record an impairment charge for the difference.

We evaluate all of our long-lived assets, including intangible assets other than goodwill, for impairment in accordance with the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets . Long-lived assets and intangible assets other than goodwill are evaluated for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. Should events indicate that any of our long-lived assets are impaired; the amount of such impairment will be measured as the difference between the carrying value and the fair value of the impaired asset and recorded in earnings during the period of such impairment.

Valuation allowance for net deferred tax assets

Deferred income taxes are provided for temporary differences between financial reporting and income tax basis of assets and liabilities, and are measured using currently enacted tax rates and laws. Deferred income taxes also arise from the future benefits of net operating loss carryforwards. A valuation allowance equal to 100% of the net deferred tax assets has been recognized due to uncertainty regarding future realization.

Accounting for stock based compensation

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized in the three and nine month periods ended June 30, 2007 includes the cost for all stock options granted prior to, but not yet vested as of October 1,

2006. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to September 30, 2006, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period.

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The Company used historical data to estimate the Option exercise and employee departure behavior used in the lattice valuation model. Expected volatility is based on historical volatility of the Company s stock. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The Company considers all employees to have similar exercise behavior and therefore has not identified separate homogenous groups for valuation. The expected term of Options granted is derived from the output of the option pricing model and represents the period of time that Options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the Options is based on the U.S. Treasury yields in effect at the time of grant.

Results of Continuing Operations

Revenue

Revenues from our business include the sale or license of Mediasite and server software products and related services contracts, such as customer support, content hosting, equipment rental, and event services sold separately. We market our products to educational institutions, corporations and government agencies that need to deploy, manage, index and distribute video content on Internet-based networks. We reach both our domestic and international markets through reseller networks, a direct sales effort and partnerships with system integrators.

Q3-2007 compared to Q3-2006

Revenues in Q3-2007 increased $1.06 million, or 29% from Q3-2006 sales of $3.65 million to $4.70 million. Sales consisted of the following:

Product revenue from sale of Mediasite capture units

	Q3-2007	Q3-2006
Units sold	213	145
Mobile to rack ratio	0.7 to 1	0.9 to 1
Average sales price, excluding support (000 s)	$ 16.6	$ 20.5
Mediasite gross margins, excluding support	67%	77%

Services revenue represents the portion of fees charged for Mediasite SmartServe service contracts amortized over the length of the contract, typically 12 months, as well as training, installation, rental, event and content hosting services. Services revenue increased from $663 thousand in Q3-2006 to $1.15 million in Q3-2007 primarily due to support contracts on new Mediasite capture units as well as renewals of support contracts entered into in prior years. At June 30, 2007 $3.12 million of unrecognized support and service revenue remained in unearned revenues, of which we expect to realize $1 million in the upcoming quarter.

Other revenue relates to freight charges billed separately to our customers, reimbursed expenses, and certain custom software engineering projects.

YTD-2007 (Nine months) compared to YTD-2006 (Nine months)

Revenues for YTD-2007 totaled $12.00 million compared to YTD-2006 revenues of $8.47 million. Revenues included the following:

$9.03 million product revenue from the sale of 493 Mediasite units versus $6.60 million from the sale of 374 Mediasite units in 2006.

$2.94 million from Mediasite services plans, installation & training versus $1.73 million in 2006.

$30 thousand from the Department of Justice research grant in 2006.

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Gross Margin

Total gross margins for Q3-2007 were $3.48 million or 74% compared to Q3-2006 of $2.84 million or 78%. The significant components of cost of revenue include:

- Material and freight costs for the Mediasite capture units. Costs for Q3-2007 Mediasite material and other costs amounted to $1.02 million, along with $24 thousand of freight costs, and $182 thousand of labor and allocated costs, resulted in Mediasite gross margins including support revenue of 74%. Total YTD costs for 2007 amounted to $2.89 million and resulted in Mediasite gross margins of 76%. Total costs for Q3-2006 amounted to $812 thousand, including $13 thousand of freight costs, $92 thousand of amortization expense, and $41 thousand of labor costs, resulting in Mediasite gross margins of 78%. Total costs of YTD-2006 amounted to $2.2 million and resulting gross margins of 73%. The gross margin on Mediasite sales varies with product mix.

- Due to the increasing significance of our services, the time devoted by internal staff to customer services has increased and we therefore began allocating a percentage of staff salaries and wages to cost of revenues in fiscal 2007. Such costs were $111 thousand in Q3-2007 and $192 thousand YTD. The cost of revenue for services in 2006 is immaterial and is included in sales and marketing expense.

- Costs associated with the acquisition of Mediasite in 2001 assigned to purchased technology and other identified intangibles were fully amortized as of December 31, 2006. Amortization expense was approximately $53 thousand for the nine month period ended June 30, 2007, and $92 thousand per quarter in 2006.

Operating Expenses

Selling and Marketing Expenses

Selling and marketing expenses include wages and commissions for sales, marketing, business development and technical support personnel, print advertising and various promotional expenses for our products. Timing of these costs may vary greatly depending on introduction of new products and services or entrance into new markets, or participation in major tradeshows.

Q3-2007 compared to Q3-2006

Selling and marketing expenses increased $1.25 million or 60% from $2.10 million in Q3-2006 to $3.35 million in Q3-2007 resulting from:

- Q3-2007 salary, commissions, bonuses and benefits exceeded Q3-2006 by $862 thousand due to the growth in revenues impacting related commissions, and salary expense for additional selling and marketing staff.

- Q3-2007 recruiting, travel, and allocated expenses increased $447 thousand as a result of increases to selling and marketing staff, including $128 thousand of non-cash stock compensation expense associated with the adoption of SFAS 123R.

- Q3-2007 market research, advertising and tradeshow expenses increased $47 thousand due to increased marketing efforts.

- Increased expenses were partially offset by an allocation of $111 thousand in technical support and services expense to cost of goods sold.

YTD-2007 compared to YTD-2006

Selling and marketing expenses increased $3.33 million or 60% from $5.57 million in YTD-2006 to $8.90 million in YTD-2007 as a result of increases in many of the same items mentioned in the quarter discussion above. YTD increases in the major categories include:

- YTD-2007 salary, commissions, and benefits exceeded YTD-2006 by $1.98 million due to the growth in revenues impacting related commissions, and salary expense for additional selling and marketing staff.

- YTD-2007 recruiting and travel costs increased $454 thousand over the prior year, due to the addition of selling and marketing staff.

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YTD- 2007 advertising and Tradeshow expenses increased $218 thousand over the prior year, reflecting expanded marketing efforts.

YTD-2007 support costs including travel, utilities and other facility related expenses increased by $731 thousand over the prior year, due to the addition of selling and marketing staff, including $378 thousand of non-cash stock compensation expense associated with the adoption of SFAS 123R.

As of June 30, 2007 we had 64 employees, excluding independent contractors and limited term employees, in Selling and Marketing compared to 35 at June 30, 2006. We anticipate continued growth in selling and marketing headcount in the remainder of fiscal 2007, although at a reduced rate from increases recorded earlier in the fiscal year.

General and Administrative Expenses

General and administrative (G&A) expenses consist of personnel and related costs associated with the facilities, finance, legal, human resource and information technology departments, as well as other expenses not fully allocated to functional areas.

Q3-2007 compared to Q3-2006

G&A expenses increased $208 thousand or 28% over the prior period from $744 thousand in Q3-2006 to $952 thousand in Q3-2007. Some significant differences between the periods include:

Depreciation and facilities expenses increased $70 thousand over the prior year due to an expansion of office space completed in Q1-2007.

Salaries, wages, and benefits increased $324 thousand over the prior year, due in part to SFAS 123R expense. This increase was partially offset by a corresponding increase in costs allocated to other functional areas.

In response to growing revenues and customer accounts receivable, the Company increased the reserve for uncollectible accounts receivable and recorded a charge of $50 thousand in Q3-2007.

YTD-2007 compared to YTD-2006

G&A increased $820 thousand or 37% from $2.21 million in YTD-2006 to $3.03 million in YTD-2007. As mentioned in the quarter discussion above, salaries, commissions and benefits increased over the prior year, resulting in a variance of $861 thousand YTD. Again, this increase was partially offset by allocating expense to other functional areas. Professional fees increased $228 thousand due to increased accounting and legal costs, including costs associated with Sarbanes-Oxley compliance.

As of June 30, 2007 we had 14 employees in G&A, excluding interns, compared to 8 at June 30, 2006. We do not anticipate significant growth in G&A headcount during the remainder of fiscal 2007.

Product Development Expenses

Product development expenses include salaries and wages of the software research and development staff and an allocation of benefits, facility and administrative expenses. Fluctuations in product development expenses correlate directly to changes in headcount.

Q3-2007 compared to Q3-2006

R&D expenses increased $244 thousand, or 41% from $593 thousand in Q3-2006 to $837 thousand in Q3-2007. Some significant differences between the periods include:

Increased salaries and benefits of $186 thousand.

Increased share of allocated G&A expenses of $80 thousand dollars including non-cash stock compensation of $46 thousand associated with the adoption of SFAS 123R on October 1, 2005.

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As of June 30, 2007 we had 26 employees, excluding limited term employees, in Research and Development compared to 19 at June 30, 2006. We do not anticipate significant growth in R&D headcount during the remainder of fiscal 2007. We do not anticipate that any fiscal 2007 software development efforts will qualify for capitalization under SFAS No. 86 Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed.

YTD-2007 compared to YTD-2006

YTD-2007 R&D expenses increased $647 thousand, or 39% from YTD-2006. As mentioned in the quarter discussion above, salaries, commissions and benefits were the primary reason for the increase, accounting for $482 thousand of the increase over the prior year. Additional contributors to the increase included facilities related expenses and non-cash stock compensation of $133 thousand associated with the adoption of SFAS 123R. In YTD-2007, 75% of R&D costs related to salaries and benefits.

Other Income

Other income is primarily interest income. We are currently investing in certificates of deposit and overnight investment vehicles.

Liquidity and Capital Resources

Cash used in operating activities was $5.62 million in YTD-2007 compared to YTD-2006 of $2.58 million an increase of $3.04 million or 118%. Cash use in 2007 included a $2.34 million increase in accounts receivable and a $432 thousand increase in prepaid expenses associated with growing revenues and expanded marketing programs allocated to future periods. 2006 had more modest changes in working capital components with a $1.1 million increase in receivables and a $123 thousand decrease in accounts payable and accrued liabilities.

Cash used in investing activities was $397 thousand in YTD-2007 compared to a use of $531 thousand in YTD-2006. Cash used in investing activities was for the purchase of property and equipment.

Cash provided by financing activities was $11.6 million in YTD-2007 compared to cash provided of $1.2 million in YTD-2006. In December 2006, we received $10.4 million from the sale of common stock, net of issuance costs, and received $328 thousand in YTD-2007 from the exercise of options and warrants compared to the receipt of $725 thousand from the sale of common stock in November 2005 and proceeds from the exercise of options and warrants of $449 thousand.

In December 2006, we issued 3 million shares of common stock in a public offering, and received net proceeds of $10.4 million for support of continuing research and development efforts and capital expenditures, intellectual property protection, as well as other business development activities, working capital needs, and general corporate purposes. In November 2005, we issued 747 thousand shares of common stock and 149 thousand common stock purchase warrants to certain individual investors in a private placement, and received net proceeds of $725 thousand. The Company believes its cash position is adequate to accomplish its business plan through at least the next twelve months and therefore has no current plan to issue additional shares previously registered in its available shelf registration.

We expect to continue to acquire property and equipment over the next twelve months including equipment associated with our anticipated growth in the number of employees, expansion of our services offering and development of new hardware components for our Mediasite product. On May 2, 2007, the Company entered into a Loan and Security Agreement (the Loan Agreement) with Silicon Valley Bank providing for a credit facility in the form of a $3,000,000 secured revolving line of credit and a $1,000,000 term loan. We may evaluate further operating or capital lease opportunities to finance equipment purchases in the future and may utilize the Company s recently established revolving line of credit to support working capital needs, if the Company deems it advisable to do so.

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. Obligations to purchase approximately $815 thousand over the next fiscal quarter remain. This commitment is not recorded on the Company s Balance Sheet. There are no obligations under this commitment past September 30, 2007. The Company had approximately $1.6 million of purchase commitments as of June 30, 2006.

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The Company engaged a manufacturer to build a replacement component for its Mediasite product according to designs proprietary to the Company. The Company had a commitment of approximately $69 thousand at June 30, 2007. There was no similar commitment at June 30, 2006.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Derivative Financial Instruments

The Company is not party to any derivative financial instruments or other financial instruments for which the fair value disclosure would be required under SFAS No. 133, Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments. The Company s cash equivalents consist of overnight investments in money market funds that are carried at fair value. Accordingly, we believe that the market risk of such investments is minimal.

Interest Rate Risk

The Company s cash equivalents are subject to interest rate fluctuations, however, we believe this risk is immaterial due to the short-term nature of these investments.

The interest rate under our revolving line of credit and term loan is subject to change based on the Silicon Valley Bank s Prime Rate. At June 30, 2007 a balance of $972,000 was outstanding on the term loan and there was no outstanding balance on the revolving line of credit.

Foreign Currency Exchange Rate Risk

All international sales of our products are denominated in US dollars.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Based on evaluations at June 30, 2007, our principal executive officer and principal financial officer, with the participation of our management team, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15 (e) and 15d-15 (e) under the Securities Exchange Act) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and that material information relating to the Company is accumulated and communicated to management, including our principal executive officer and our principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

Changes in Internal Controls

During the period covered by this quarterly report on Form 10-Q, the Company has not made any changes to its internal control over financial reporting (as referred to in Paragraph 4(c) of the Certifications of the Company s principal executive officer and principal financial officer included as exhibits to this report) that have materially affected, or are reasonably likely to affect the Company s internal control over financial reporting.

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PART II

OTHER INFORMATION

ITEM 6. EXHIBITS

NUMBER	DESCRIPTION
3.1	Amended and Restated Articles of Incorporation of the Registrant, filed as Exhibit No. 3.1 to the registration statement on amendment No. 2 to Form SB-2 dated April 3, 1998 (Reg. No. 333-46005) (the Registration Statement), and hereby incorporated by reference.
3.2	Amended and Restated By-Laws of the Registrant, filed as Exhibit No. 3.2 to the Registration Statement, and hereby incorporated by reference.
10.1*	Registrant s 1995 Stock Option Plan, as amended, filed as Exhibit No. 4.1 to the Registration Statement on Form S-8 on September 8, 2000, and hereby incorporated by reference.
10.2*	Registrant s Non-Employee Directors Stock Option Plan, filed as Exhibit No. 10.2 to the Registration Statement, and hereby incorporated by reference.
10.3*	Employment Agreement between Registrant and Rimas Buinevicius dated as of January 1, 2001, filed as Exhibit 10.4 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2000, and hereby incorporated by reference.
10.4*	Employment Agreement between Registrant and Monty R. Schmidt dated as of January 1, 2001, filed as Exhibit 10.5 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2000, and hereby incorporated by reference.
10.5*	Registrant s Amended 1999 Non-Qualified Plan, filed as Exhibit 4.1 to Form S-8 on December 21, 2001, and hereby incorporated by reference.
10.6	Commercial Lease between West Washington Associates LLC and Sonic Foundry, Inc. regarding 222 West Washington Ave., Suite 775, Madison, WI, dated August 1, 2003 filed as Exhibit 10.21 to Form 10-K filed on December 23, 2003 and hereby incorporated by reference.
10.7	Amendments to Commercial Lease between West Washington Associates LLC and Sonic Foundry, Inc. regarding 222 West Washington Ave., Suite 775, Madison, WI, dated May 17, 2006 and June 5, 2006, filed as exhibit 10.7 to Form 10-K on November 16, 2006, and hereby incorporated by reference.
10.8	Loan and Security Agreement dated May 2, 2007, between Sonic Foundry, Sonic Foundry, Inc,, Sonic Foundry Media Systems, Inc. and Silicon Valley Bank filed as Exhibit 10.1 to Form 8-K on May 7, 2007, and hereby incorporated by reference.
10.9	Intellectual Property Security Agreement dated May 2, 2007, between Sonic Foundry, Inc. and Silicon Valley Bank filed as Exhibit 10.2 to Form 8-K on May 7, 2007, and hereby incorporated by reference.
10.10	Intellectual Property Security Agreement dated May 2, 2007, between Sonic Foundry Media Systems, Inc. and Silicon Valley Bank filed as Exhibit 10.3 to Form 8-K on May 7, 2007, and hereby incorporated by reference.
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32	Section 906 Certification of Chief Executive Officer and Chief Financial Officer

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Registrant will furnish upon request to the Securities and Exchange Commission a copy of all exhibits, annexes and schedules attached to each contract referenced in item 10.

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* Compensatory Plan or Arrangement

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SIGNATURES

Pursuant to the requirement of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Sonic Foundry, Inc.

(Registrant)

August 6, 2007	By:	/s/ Rimas P. Buinevicius Rimas P. Buinevicius Chairman and Chief Executive Officer
August 6, 2007	By:	/s/ Kenneth A. Minor Kenneth A. Minor Chief Accounting and Financial Officer and Secretary